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UNCLAS SECTION 01 OF 03 TAIPEI 001560

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STATE FOR EAP/RSP/TC, EAP/EP AND EB/IFD/OIA

USTR FOR SCOTT KI

USDOC FOR 4420/USFCS/OCEA/EAP/LDROKER  
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TREASURY FOR OASIA/ZELIKOW AND WISNER

TREASURY PLEASE PASS TO OCC/AMCMAHON

TREASURY ALSO PASS TO FEDERAL RESERVE/BOARD OF  
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E.O. 12958: N/A

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SUBJECT: Taiwan's Growth Continues Slowing

SUMMARY

1. The slowing trend of Taiwan's economic growth has continued from the second half of 2004 into the first two months of 2005. Export growth has declined steadily. Industrial production has gone from growth to decline, while unemployment has edged-up for the first time in the past seven months. Higher prices of crude oil and other raw materials from abroad have brought inflationary pressure, prompting Taiwan's Central Bank of China (CBC) to raise interest rates. Economists have mixed expectations for Taiwan's 2005 economic performance, but a growing number anticipate the economy will continue to slow into 2006 due to currency appreciation and higher interest rates. END SUMMARY.

Economic Slowdown  
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2. In 2004, Taiwan's economic growth dropped from 7.3% in the first half of the year to 4.7% in the second half. Although Taiwan's Directorate General of Budget, Accounting and Statistics predicts the growth rate will stay above 4.5% throughout 2005, economic think tanks are less optimistic. The Chunghua Institution for Economic Research predicts growth rates will continue declining to barely above 4% in the second half of 2005. A leading indicator of economic growth compiled by the Council for Economic Planning and Development (CEPD) posted its fifth straight monthly decline in February 2005, down 1.3% compared to the previous month. The manufacturing facility utilization rate fell to 77%, the lowest in the past two years. Profits as a share of sales dropped to 4.6%, lowest in the past 18 months.

3. Trade and production figures also indicate economic slowdown. Taiwan's export growth on a y-o-y basis slipped from 29% in Q2 of 2004 to 8% in the first two months of 2005, while import growth dropped from 40% to 11%. Industrial production in the first two months of 2005 declined 0.5% from a year ago, compared to a growth rate of 14% for Q1 and 15% for Q2 of 2004. Capital- and technology-intensive industries, the backbone of Taiwan's industrial sector, declined 0.2% in the first two months of 2005, compared with growth of 15-16% in early 2004.

Rise in Unemployment  
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4. Unemployment rose for the first time in seven months. Taiwan's unemployment rate in February 2005 was 4.28%, the highest since November 2004. Nevertheless, unemployment is still lower than the 4.61% of a year ago. About 55% of jobless persons are in the 25-44 age bracket.

Inflationary Pressure Leads to Higher Interest Rates  
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5. Higher petroleum and other raw material prices raised Taiwan's consumer price index in February 2004 to 1.94%, higher than the average interest rate of 1.2% for overnight call loans. The negative real interest rates prevailing in eight of the past nine months prompted the CBC to raise interest rates by 0.125 percentage points on March 25. The discount rate rose from 1.75% to 1.875%, still lower than the U.S. Federal Reserve Board's benchmark Federal Funds interest rate. David Hong, Acting President of the Taiwan Institute of Economic Research (TIER), said that he expects the CBC will continue to raise interest rates as long as interest rates in the United States are higher than in

Taiwan. On March 22, the U.S. Federal Reserve Board raised its benchmark interest rate by 0.25 percentage points to 2.75%.

#### Growing Optimism in Business Community

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16. In spite of the economic slowdown, Taiwan's business sector is optimistic. According to a TIER survey done in March 2005, 55% of respondents expected better business performance in the next six months, up from 27% in February. The share of business people anticipating declining performance dropped from 18% to 8.5%. A survey conducted by the Council for Economic Planning and Development (CEPD) produced a similar result.

#### Economists' Mixed Expectation

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17. Economists have mixed expectations for Taiwan's economic performance in 2005. TIER senior economist Chen Miao told AIT that the government's industrial development program and public construction projects would stimulate economic expansion in the second half of this year. In March 2005, the Executive Yuan (EY) approved an eight-year flood control project costing NT\$80 billion. The EY has also recently decided to offer incentives for emerging industries, such as flat panel (TFT-LCD) and biotech products. TIER's Chen Miao expected the NT dollar (NTD) to continue to appreciate this year. The Chunghua Institute of Economic Research (CIER) predicted Taiwan's economy will turn up in the last quarter of 2005. Dr. Chou Chi, Director of the CIER's Economic Forecasting Center, told AIT he expected the better economic performance to continue into 2006.

18. However, Ho Chi-wen, President of Morgan Stanley (Taiwan), and Chu Yun-pen, Director of National Central University's Taiwan Economic Center, are pessimistic about Taiwan's economy. In a recent seminar sponsored by the Monte Jade Science & Technology Association of Taiwan, both of them forecast that Taiwan's investment expansion and economic growth in 2005 will slow significantly because higher interest rates will dampen consumption in the United States, an important export market. Morgan Stanley's Ho Chi-wen indicated that the slowdown in Taiwan's 2005 economic growth is also caused by saturation of global demand for information & technology (IT) products. Production will increase, but competition will drive down prices and squeeze profit margins. According to Ho, Taiwan's economic growth in 2005 and 2006 must rely on increases in private consumption, which has posted an annual growth rate of 3% or less over the past four years.

19. See tables on our AIT/T/Econ Intranet website for latest economic indicators:  
[http://taipei.state.gov/ait\\_s/econ/econ\\_web/e\\_conhome.htm](http://taipei.state.gov/ait_s/econ/econ_web/e_conhome.htm)  
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